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SUBJECT: INDONESIA - 2008 DRAFT BUDGET, SIGNIFICANT INCREASE IN INFRASTRUCTURE SPENDING

¶11. (U) Summary. On August 16, President Susilo Bambang Yudhoyono (SBY) presented to the Parliament his FY 2008 draft budget, which focused heavily on boosting infrastructure spending. The draft budget targets 6.8% economic growth for 2008, up from 6.3% expected in 2007, with 6% inflation. In order to stimulate the economy, the Government of Indonesia (GOI) proposed a 12% increase in overall spending for 2008 to Rp 836.4 trillion (\$91.5 billion); revenue is to increase 11.2% to Rp 761.4 trillion (\$83.3 billion) from 2007. Under the plan, the budget deficit should increase 21%, to 1.7% of GDP from 1.6% expected this year, reflecting the GOI's attempt to drive economic growth by boosting overall spending volume. The 2008 budget is still under Parliamentary review. End Summary.

¶12. (U) Note. This report uses the September 27 Rp 9140/USD market exchange rate rather than the GOI's budget assumption exchange rate of Rp 9,100/USD. The GOI uses a calendar year fiscal year. End Note.

Macro Assumptions:

Deficit Expands to Stimulate Economy

¶13. (U) The 2008 draft budget is based on a stronger economic growth rate and results in a significantly larger deficit. It assumes 6.8% growth in 2008, up from 6.3% expected for 2007 and generates a deficit of 1.7% deficit-to-GDP, compared to 1.6% deficit-to-GDP in the 2007 revised budget. The 2008 budget proposal also assumes that inflation will ease to 6% from an expected 6.5% this year, and that Bank Indonesia (BI) will reduce its reference rate to 7.5%. In addition, it assumes an average dollar exchange rate of Rp 9,100, up from Rp 9,050 in the 2007 budget.

¶14. (U) In his address to Parliament on August 16, SBY noted "The rise in the budget deficit is in line with GOI's fiscal policy orientation of providing fiscal stimulus to the economy." SBY also indicated that the key thrusts of his 2008 budget are improving Indonesia's infrastructure and alleviating poverty. In a speech on September 25, Finance Minister Sri Mulyani also underscored the government's desire to ramp up spending in the near term. She noted that the GOI is in the process of expanding spending during the second half of 2007, potentially increasing the 2007 deficit to 1.5% of GDP.

Table 1: FY 2008 State Budget Assumptions

Macro indicators	2007 Budget	2007 Proposed Revision	2008 Draft Budget
GDP (Rp trillion)	3,779	3,804	4,306
Economic growth (%)	6.3	6.3	6.8
Inflation (%)	6.5	6.5	6.0
Exchange rate (Rp/\$)	9,300	9,100	9,100
3-month SBI rate (%)	8.5	8.0	7.5
Oil price (\$/barrel)	63	60	60
Oil lifting (mbd)	1.000	0.950	1.034

(Note: The oil price of \$60 per barrel is the estimated real price in 2007, so the GOI uses it for 2008 projection.)

Capital Expenditure, Infrastructure Increases

¶4. (U) On September 20, Parliament's Budget Committee approved the proposed state expenditures at Rp 836.4 trillion (\$91.5 billion), 14.3% up from the 2007 budget. It consists of central expenditures of Rp 564.6 trillion (\$61.8 billion) and regional expenditures of Rp 271.8 trillion (\$29.7 billion). Key spending highlights of the final budget include:

-- Capital expenditure to increase by 49% to Rp 101.5 trillion (\$11.1 billion) compared to the current budget. Social welfare programs will also rise by 42%, to Rp 67.4 trillion (\$7.4 trillion). "The government is determined to become increasingly focused in its fiscal policies to develop and repair infrastructure that is strategic to the economy, and to increase programs to enhance education, health and the prosperity of the poor," SBY stated. The

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poor condition of Indonesia's infrastructure is a growing obstacle to much-needed foreign and domestic investment and economic growth.

-- Fuel and power subsidies, although smaller than in the previous year, remain high at Rp 46.7 trillion (\$ 5.1 billion) and Rp 27.8 trillion (\$ 2.8 billion), respectively.

-- The public works ministry's budget allocation will rise 41.1% to Rp 35.6 trillion (\$3.9 billion), for building roads, and rehabilitating and maintaining existing ones. The transport ministry's allocation will jump 64.1% to Rp 16.2 trillion (\$1.8 billion) to expand the railway network, maritime transport and airports.

-- Transfers to the regions decreased as percentage of GDP over the previous year in the 2007 budget, from 6.6% to 6.3% of GDP. By nominal terms, however, it increased slightly by 8% from Rp 252.5 trillion (\$27.6 billion) to Rp 271.8 trillion (\$29.7 billion). The increase includes a 4% increase in the Revenue Sharing Fund (DBH) to Rp 64.5 trillion (\$7.1 billion), and a 7% increase in the General Allocation Fund (DAU) to Rp 176.6 trillion (\$19.3 billion).

Social Welfare Spending Rises

¶5. (U) Personnel and social spending will increase significantly, in line with the GOI's policy of bureaucratic reform, and poverty reduction. The GOI will channel the bulk of the 2007 social expenditures through line ministries for social assistance. Spending categories include direct subsidies for education and health programs, and a Rp 1.1 trillion (\$120.4 million) conditional cash transfer. The conditional cash transfer program represents an extension of similar programs introduced after fuel subsidy cuts in October 2005 to mitigate the impact of higher fuel prices on the poorest families. The cash transfer programs distributed Rp 15.6 trillion (\$1.7 billion) in 2006 and Rp 2.8 trillion (\$306.3 million) in 2007 to millions of households below a designated income level. Social expenditures also include a Rp 3 trillion (\$382.2 million) emergency reserve and disaster mitigation fund.

Table 2 provides the spending levels of GOI'S FY 2007 proposed

budget.

Table 2: FY 2008 Expenditures
(in trillions of Rupiah)

Items	2007 Proposed Revision	2008 Draft Budget	% Increase
Expenditures	746.4	836.4	12.1
-- Central govt.	493.9	564.6	14.3
- Personnel	99.9	129.5	29.6
- Material	62.5	52.4	-16.2
- Capital	68.3	101.5	48.6
- Interest	86.3	91.5	6.1
- Subsidies	105.1	92.6	-11.9
- Social	47.5	67.4	41.8
- Others	24.1	29.6	22.5
-- Transfers to regions	252.5	271.8	7.6

Education and Health Spending Increases

¶6. (U) In line with GOI's policy to increase spending on social development, the Ministry of Education (MOE) receives the highest budget allocation at Rp 48.3 trillion (\$5.3 billion). This is more than double its 2005 budget, or 17% of central government spending, 22.5% up from 2007 education budget realization. Nationwide education assistance programs include school buildings, books, and scholarships. The Ministry of Religious Affairs (MORA) budget allocation increases by 30% mainly due to a expenditure classification change: the amount includes part of the School Operational Subsidy (BOS), for Islamic schools or "madrasah," which in previous years was classified under Ministry of Education spending.

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-- Also in line with the President's social development agenda, the amount of funds allocated to the Ministry of Health increased by 18% compared to the previous year, rising to Rp 18.8 trillion (\$2.1 billion). The Health Ministry's budget will have almost tripled from 2005.

Table 3 illustrates the budget level of the ten agencies who will receive the largest budget allocations in 2008. The allocation for major agencies increased, with the exception of the Aceh Rehabilitation and Reconstruction Agency (BRR).

Table 3: FY 08 Budget Allocation By Ministries/
Agencies (in trillions of Rupiah)

Ministries/ Agencies	2007 Budget Revision	2008 Proposed Budget	% Increase
Education	39.4	48.3	22.5
Public Works	25.3	35.6	41.1
Defense	29.6	33.7	13.9
National Police	17.8	20.9	17.3
Health	15.9	18.8	18.0
Transportation	9.9	16.2	64.1
Religious Affairs	12.4	16.1	30.0
Finance	8.6	10.3	19.7
Agriculture	7.9	8.9	12.7
BRR (1)	9.9	7.0	-29.7

(1) Aceh Rehabilitation and Reconstruction Agency

Civil Service Salary Increases

¶7. (U) The GOI significantly increased personnel expenditures, by

30% in nominal terms over 2007, reflecting the GOI's civil service reform effort. The civil service reform package includes a 20% increase in base salaries and retirement benefits for the civil service, the military, the police; an increase in teacher allowances; and an increase in official per diem for the police and the army (from Rp 30,000/day to Rp 35,000/day, or \$3.3/day to \$3.8/day) as well as the civil service (from Rp 10,000/day to Rp 15,000/day, or \$1.1/day to \$1.6/day).

18. (U) The draft 2008 budget allocated increases to prioritized four government institutions that will implement civil service remuneration reforms; the National Police, the National Land Agency (BPN), the Attorney General Office (AGO), and the Investment Coordinating Board (BKPM). This follows four other institutions that initiated the project in 2007 (the Ministry of Finance, the State Audit Agency, the Supreme Court, and the State Ministry for the Administration).

Increased Anti-Corruption Spending

19. (U) All but one the major anti-corruption agencies received spending increases. The Supreme Audit Board (BPK) the Supreme Court, and the Ministry of Law and Human Rights (MOLHR) continue a multi-year trend of budget increases. Only the Corruption Eradication Commission (KPK), which has recently moved into its newly-renovated building and had large budget support in the past, has slowed down. The KPK also continues to receive robust donor assistance.

Table 4: FY 08 Budget Allocation for Civil Services Reform and Fighting Corruption (in trillions of Rupiah)

Ministries/ Agencies	2007 Budget Revision	2008 Proposed Budget	% Increase
National Police	17.8	20.9	17.3
BPN	2.3	2.4	6.3
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Attorney General	1.5	1.8	19.9
Investment Board	0.31	0.35	10.8
BPK	1.1	1.3	21.3
Supreme Court	2.8	3.2	16.3
MOLHR	3.8	4.3	13.6
KPK	0.32	0.26	-18.7

Key Revenue and Financing Highlights

110. (U) The GOI projected an 11% nominal increase in revenue in 2008 over 2007 to Rp 761.4 trillion (\$83.3 billion). The increase is predicated on higher tax receipts, which are expected to increase by 19% in nominal terms to Rp 583.7 trillion (\$63.9 billion) or 14% of 2008 GDP. Tax revenue accounts for approximately 77% of government income in the 2008 budget. Table 5 provides summarized revenues for FY 2008.

Table 5: FY 2008 Revenue (in trillions of Rupiah)

Items	2007 Budget	Revised Budget	2008 Draft Budget
Domestic Revenue	681.8	759.3	
- Oil and gas	142.9	153.3	
- Non-oil and gas	538.9	606.0	
Foreign Grants	2.7	2.1	
Tot. Revenue/Grants	684.5	761.4	

111. (U) The projected 2008 budget deficit is Rp 75 trillion (\$8.2 billion), equivalent to 1.7% of GDP. In nominal amount, the 2008 projected deficit-to-GDP ratio rises by 21% on calls for increased

government spending to spur growth. The GOI will mainly finance the deficit through bond issuances. The GOI continues to rely more heavily on domestic financing at around 85-15% proportion as in ¶2007. The GOI projected net privatization proceeds of Rp 1.5 trillion (\$164.1 million) for 2008. Table 6 provides the breakdown of the budget's source of financing.

Table 6: FY 08 Financing
(in trillions of Rupiah)

Items	2007 Revised Budget	2008 Draft Budget
Primary balance	24.3	16.5
Deficit	(61.9)	(75.0)
Financing	61.9	75.0
-- Domestic (net)	74.6	91.7
- Bank financing	10.6	0.3
- Privatization	2.0	1.5
- Assets restructuring	1.7	0.3
- Govt bonds (net)	62.3	91.6
- Infrastructure		
Supporting	(2.0)	(2.0)
-- Foreign loans (net)	(12.6)	(16.7)

Finance Minister Describes Direction,
Highlights Risk to Fiscal Stability

¶12. (U) In a September 25 briefing for the international community in Jakarta, Finance Minister Mulyani detailed her Ministry's ongoing plans for fiscal reform. The plans include streamlining administrative procedures, modernizing customs processes, improving debt management, deepening debt market, developing sound risk sharing schemes for public private partnerships, and reforming the bureaucracy. Efforts to improve the quality of the bureaucracy range from better job evaluation and remuneration to improving policy credibility.

¶13. (SBU) Minister Mulyani also detailed the risks to fiscal stability in Indonesia. Her largest concerns were global macroeconomic instability, a rise in government debt burden, the need to fund massive infrastructure projects, and a decline in the

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performance of state-owned enterprises. She also raised concerns about decentralization, both in terms of local governments' ability to spend funds to stimulate local economic activity and in terms of local governments' ability to build fiscal capacity. She conceded that local governments still face difficulties in effectively managing and implementing budgets. She listed the prevalence of natural disasters in Indonesia as a significant ongoing contingent liability for the national budget.

Comment

¶14. (SBU) The draft budget reflects the GOI's attempts to stimulate economic growth by upgrading infrastructure, after leaving economic growth mainly to private consumption in recent years. It has significantly increased spending volume to help drive economic growth, however analysts view that the key to stimulating higher GDP output is the timely disbursement of funds rather than the absolute amount of resources. Recently, some government project managers have been reluctant to spend for fear of being charged with abuse of public funds without clear procurement guidelines. The budget clearly tries to address years of low education and social welfare spending with large increases. Although the 2008 budget is conceptually good, some observers have criticized it as overly ambitious. According to the critics, the GOI has focused more on monetary goals (macroeconomic stability, lower inflation, stable exchange rate) and neglected priorities such as investment in the real sector, job creation, and poverty reduction.

Table 7: FY 2007 Revised Budget and FY 2008 Draft Budget

Items (1)	FY 2007		FY 2008	
	Rp Trill	% of GDP	Rp Trill	% of GDP
<u>I</u> A. Total revenue	684.5	18.0	761.4	17.7
<u>I</u> I. Domestic revenues	681.8	17.9	759.3	17.6
Tax revenues	489.9	12.9	583.7	13.6
Domestic taxes	472.8	12.4	568.3	13.2
Int. trade tax	17.1	0.5	15.4	0.4
Non-tax revenues	191.9	5.0	175.6	4.1
Natural resources	112.2	2.9	119.8	2.8
SOE profits	21.6	0.6	20.4	0.5
Other	58.2	1.6	35.5	0.8
II. Grants	2.7	0.1	2.1	0.0
<u>I</u> B. Expenditures	746.4	19.6	836.4	19.4
Central govt. exp.	493.9	13.0	564.6	13.1
Routine	162.4	4.2	181.9	4.2
-Personnel	99.9	2.6	129.5	3.0
-Material exp.	62.5	1.6	52.4	1.2
Capital exp.	68.3	1.8	101.5	2.4
Interest payments	86.3	2.3	91.5	2.1
Subsidies	105.1	2.8	92.6	2.2
Social assistance	47.5	1.2	67.4	1.6
Other expenditure	24.1	0.6	29.6	0.7
Transfer to regions	252.5	6.6	271.8	6.3
Primary balance	24.3	0.6	16.5	0.4
Overall balance	(61.9)	(1.6)	(75.0)	(1.7)
Financing	61.9	1.6	75.0	1.7
Domestic financing	74.6	2.0	91.7	2.1
Domestic banks	10.6	0.3	0.3	0.0
Privatization	2.0	0.1	1.5	0.0
Assets restructuring	1.7	0.0	0.3	0.0
Govt debt	62.3	1.6	91.6	2.1
Capital participation	(2.0)	(0.1)	(2.0)	(0.0)
Foreign financing (net)	(12.6)	(0.3)	(16.7)	(0.4)
Gross drawing	42.4	1.1	43.0	1.0

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Program loan	19.1	0.5	19.1	0.4
Project loan	23.3	0.6	23.9	0.6
Amortization of foreign debt (net)	(55.0)	(1.4)	(59.7)	(1.4)

(1) Column totals may not add perfectly due to rounding.

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